Market briefing: December 2021

Key developments in the housing and mortgage markets

Bob Pannell

Economic Adviser, IMLA

Executive Summary

- Concerns about the Omicron variant arise at a time when economic growth is already stalling because of raw material and labour shortages. While it is too early to be confident about ramifications for the wider economy, there is comfort in knowing that the UK is well-placed to implement whatever coping strategies are appropriate.

- The sharp upwards spike in consumer price inflation over recent months prompted the Bank of England in mid-December to increase Bank Rate from its historic low of 0.1% to 0.25%, the first tightening of monetary policy in more than three years.

- Stamp duty arrangements have returned to their pre-pandemic settings across all parts of the UK, with no obvious ill effects. Housing demand and house prices continue to be supported by lifestyle preferences, still low interest rates and attractive mortgage pricing.

- 2022 is expected to be a strong year for refinancing activity and this will help to shelter mortgage lenders and brokers from any slowdown in the housing market.

- Lenders are alert to and well-placed to support households hit by rising cost of living pressures over the coming months and to minimise any adverse impact on arrears and possessions.

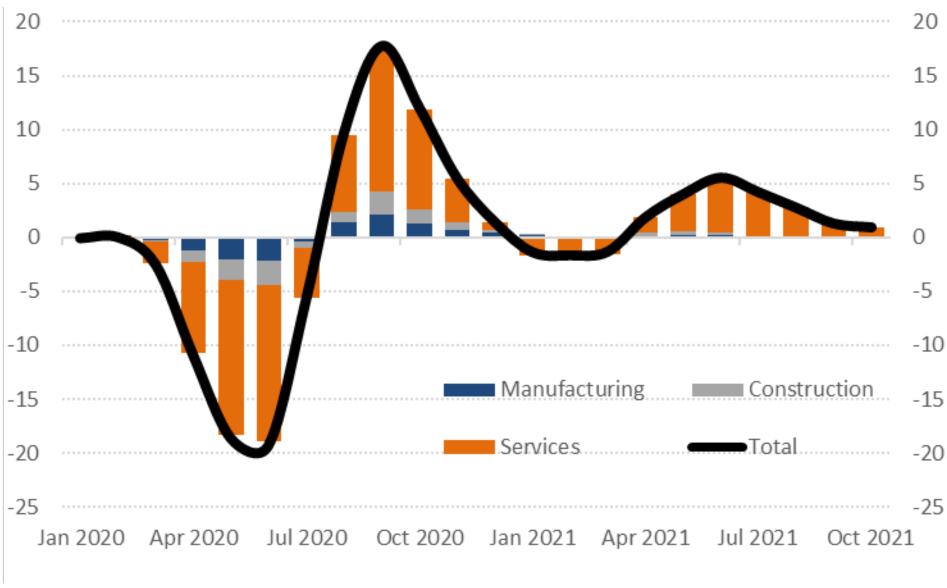
The Economy

UK economic growth slowed noticeably in the third quarter of the year, primarily because supply chain bottlenecks dragged down the manufacturing and construction sectors. There were also signs of weaker consumer spending although this may in part be a result of product shortages affecting the availability of new cars, electrical goods and furniture.

The story has not changed with the monthly GDP figures for October, which show that the UK economy grew by just 0.1% and is still 0.5% below its pre-pandemic level. The construction sector, still beset by rising input prices and product availability issues, saw a relatively sharp decline in activity (-1.8%), in part reflecting a drop in new-build housing.

From the rolling 3-month data, we see that economic growth has become almost entirely dependent upon further recovery in the services sector.

Chart 1: Sources of GDP growth, %



Source: Office for National Statistics
Note: Figures show contribution to growth, latest 3 months on previous 3 months.

Looking ahead, economic prospects are once again being overshadowed by the Covid-19 pandemic, with the latest Omicron variant threatening to undermine the recovery, heap further pressure on global supply chains and complicate monetary policy decisions.

Faced with uncertainty, there are already signs of firms and individuals adopting a more cautious approach, and this is likely to drag on growth in the services sector particularly those areas related to travel and hospitality through December.

While we have all gained significant resilience and flexibility as a result of previous social distancing measures, too little is currently known about the transmissibility and deadliness of Omicron at this juncture to make confident predictions about the trajectory for the economy beyond the next few months.

The current stance of fiscal policy is already expansionary - see boxed article on Budget and Spending Review – and so will help mitigate some of the adverse impacts from Omicron. And as we know from the last two years, the Government has ample fiscal firepower should a fresh smorgasbord of Government measures become appropriate.

Jobs market

The good news is that we are starting from a relatively favourable position with respect to jobs, with the unemployment rate in the August-October period decreasing by 0.4% over the previous three months to stand at 4.2%.

Survey findings continue to suggest that only a small share of those still on furlough when the scheme closed at the end of September have been made redundant. Payroll numbers stood at 29.4 million in November 2021, up by 257,000 on October and by 424,000 on the pre-Covid level. While the rate of growth in vacancies has slowed over recent months, the latest total of 1,219,000 sets a new record and is more than 50% higher than pre-coronavirus.

On the earnings front, regular pay (excluding bonuses) in August to October was 4.3% higher than a year ago. This metric provides a much truer reading than of late, now that upwards distortions caused by base and compositional effects have largely worked their way out of the figures.

Budget and Spending Review

A large and sustained increase in public spending over the three years to 2024-25 was the centre-piece of Rishi Sunak's October Budget and Spending Review (SR21).

Total departmental spending is set to grow in real terms at 3.8% a year on average over this Parliament – a cash increase of £150 billion a year by 2024-25 (£90 billion in real terms). Although half of the extra spending goes on the NHS and social care, overall spending by every Government department will increase in real terms over the period.

At the same time, the Chancellor also adheres to newly set fiscal rules to ensure that public sector net debt falls as a percentage of GDP.

How has he achieved this?

The rebound in economic activity over recent quarters has meant higher tax revenues and lower spending on pandemic-related support measures, improving the state of public finances ahead of October's Budget. The Office for Budget Responsibility (OBR) now estimates a budget deficit of £183 billion in 2021-22, £51 billion lower than it expected in March.

The OBR also expects the pandemic to have a smaller scarring effect on the economy than previously forecast, which implies a larger economy in the medium term with higher tax revenues, lower unemployment and higher wages.

Whilst a stronger than expected recovery since March undoubtedly helps the fiscal arithmetic, much of the heavy lifting is being done by pre-announced measures.

October's Budget and Spending Review actually marks the third major fiscal event of 2021.

The Spring Budget in March increased corporation tax and froze income tax personal allowance and higher rate threshold at 2021-22 levels through to 2025-26. This represents a marked fiscal tightening over the medium-term (worth more than £30 billion a year by 2025-26).

In September, the Government announced a new 1.25% Health and Social Care Levy and a 1.25% increase in dividend taxation from April 2022 to fund investment in the NHS and social care. It also modified the triple lock mechanism for uprating state pensions. The decision to suspend the earnings link element for next year avoids the distortion in the annual growth in earnings caused by the pandemic and saves HM Treasury more than £5 billion in 2022-23 and future years.

Taken overall, the £30 billion or so added to departmental budgets in each year of the Spending Review period is more than offset by higher tax revenues, so allowing Government borrowing to fall away.

One consequence of the Government's measures is that the tax burden is set to rise from 33.5% of GDP before the pandemic to 36.2% of GDP by 2026-27. This would be the highest level since the early 1950s (although the Chancellor is understood to have pencilled in tax cuts ahead of the next general election).

Inflation and interest rates

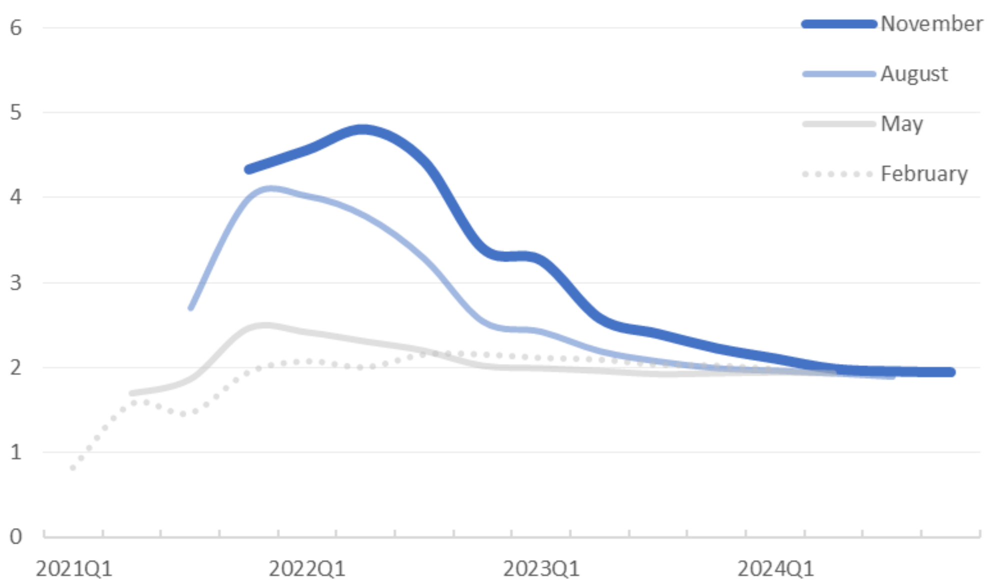
Although Rishi Sunak's Budget and Spending Review represents a modest boost to the economy over the next year or so, it failed to generate much of a "feel good" factor. The Office for Budget Responsibility rather grabbed the headlines, with its view – now widely held - that CPI inflation could peak at 5% or more next year – its highest rate for three decades – and trigger Bank Rate increases.

There has been a growing narrative about the pressure on household finances in recent weeks.

Part of this reflects planned tax increases from next April, when frozen income tax allowances and thresholds and higher national insurance contributions all take effect. But inflationary pressures, associated with product and labour market shortages and supply disruptions, are a broader concern.

CPI inflation has risen very sharply in recent months, with the consumer prices index hitting 5.1% in November, up from 4.2% in October and 3.1% the month earlier. This was the highest reading in more than ten years. While recent figures have been distorted by comparisons with lockdown periods last year, the jump was driven mainly by rising prices for motor fuel, used cars and household energy.

Chart 2: How the Bank's view of inflation has changed



Source: Bank of England

Inflationary pressures have proved quite a challenge for the Bank of England. Its credibility has been undermined to some extent because it has consistently understated the likely extent of CPI inflation over the past year (see Chart 2).

The Monetary Policy Committee (MPC) (rightly) sees much of the uptick in inflation as temporary in nature, linked to higher energy bills and other one-off factors, and the prevailing wisdom within the Committee until quite recently has been to look through any short-term spike in CPI numbers.

As CPI inflation has risen sharply in recent months and it has become evident that supply disruptions may take some time to unwind, however, the Committee has concluded that some modest tightening of monetary policy would be necessary to meet its 2% inflation target sustainably in the medium term. It has become a question of when, rather than if, the Bank would tighten monetary policy.

Financial markets had reasoned that the MPC might hold off from tightening monetary policy until the New Year, given that the emergence of the Omicron variant would dull near-term economic growth.

In the event, the MPC revealed in mid-December that it now expects consumer price inflation to hit 6% in April next year - that is, a peak a full percentage point higher than it forecast in early November – and decided to increase Bank Rate by 0.15% to 0.25%. This is the first tightening of monetary policy since August 2018.

Housing and mortgage markets

Activity

While housing demand has been underpinned by significant changes in lifestyle and housing preferences post-coronavirus, the pattern of market activity this year has been heavily influenced by stamp duty arrangements, with significant spikes in property sales in March, June and September, coinciding with the dates when concessions in different parts of the UK ended or were materially reduced (see Chart 3).

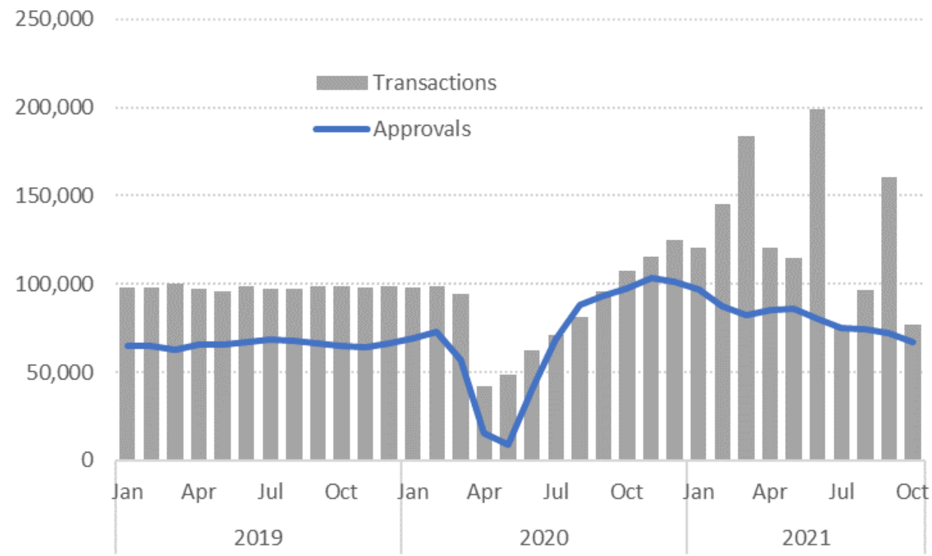
Taken overall, rolling 12-month sales have recently climbed above 1½ million – their highest level since the global financial crisis (GFC).   About one in 16 privately owned homes will have changed hands this year, according to Zoopla.

Stamp duty arrangements in all parts of the UK have now reverted to their pre-pandemic settings, with the last remaining concessions in England and Northern Ireland coming to an end in September.

Thinking about who gained most from the stamp duty holidays, it is clear that existing home-owners moving home were a major beneficiary. There were 489,000 households moving (and still needing a mortgage) in the year to September – the highest level since 2007 and the highest share of regulated house purchases since 2016. Many other existing home-owners will also have transacted for cash over the past year.

It also marked the strongest period for buy to let landlords purchasing homes since before the 3% stamp duty surcharge was introduced in 2016, with a particular focus in London, the South East and the South West according to Paragon Bank. In the year to September, buy to let landlords bought more than 110,000 properties. These accounted for about 7.3% of overall property transactions, a full percentage point higher than pre-pandemic, albeit significantly below peak landlord levels.

Chart 3: Property transactions and approvals for house purchase, monthly



Source: HMRC, Bank of England

There was an inevitable drop-off in transactions in October. Residential sales more than halved in October, to 77,000, and this was the first time in more than a year when sales fell year-on-year.

This reversal had a corresponding effect on industry gross and net lending, which contracted to £19.3 billion and £1.6 billion respectively, and in both cases the lowest readings since July. The rolling 12-month totals of £315 billion and £80 billion corroborate that 2021 will represent the strongest performance for mortgages since the GFC.

Although approvals for house purchase have not followed the same see-saw pattern as sales, we can also see that the trend is clearly downwards. Lending levels in August, September and October have been well below year-earlier levels. The 67,000 approvals posted in October was the weakest since July 2020.

By contrast, remortgage approvals have moved higher since mid-year. Activity in the past two months was the strongest since early 2020, part of a shift of focus away from house purchase to refinance activity. According to the latest credit conditions survey from the Bank of England, Q4 will see weaker demand for secured lending for house purchase but a sharp increase in remortgage demand. CACI suggests that strong remortgage demand will persist through much of 2022, based on an analysis of maturing deals. A greater focus on refinancing will help to offset the expected softening in house purchase activity next year.

Prices and rents

Despite stamp duty holidays coming to an end, there have continued to be high levels of housing demand and relatively strong property price increases.

Several indices suggest a less frenetic market, but still one where prices are increasing at an annual rate of 8-10%, underpinned by limited available stock of property for sale and competitive mortgage rates. The latest Office for National Statistics figures suggest that average prices increased by 10.2% over the year to October, down from 12.3% in September.

The regional picture has not changed dramatically in recent months, with Wales continuing to be the most buoyant market. Whilst London continues to lag the rest of the UK, prices have firmed noticeably over the past couple of months.

Table 1: How property prices have changed regionally.

				Pecentage change	
	October 2021	October 2020	March 2020	Year on Year	Since March 2020
North East	£147,719	£134,715	£128,306		
North West	£195,325	£177,827	£166,588		
Yorks and Humber	£193,675	£174,360	£165,360		
East Midlands	£228,290	£204,424	£195,701		
West Midlands	£226,279	£208,805	£199,637		
East	£332,216	£298,840	£288,077		
London	£516,285	£486,212	£482,605		
South East	£366,883	£332,489	£323,167		
South West	£298,600	£271,744	£259,458		
England	£285,113	£259,592	£249,121		
Wales	£203,224	£175,948	£167,040		
Scotland	£181,391	£163,019	£150,625		
Northern Ireland	£159,109	£147,475	£140,722		

Source: Office for National Statistics

Pre-Omicron, most commentators were looking for a further slowdown in price rises through 2022 rather than price falls, notwithstanding some pressure on household finances and the prospect of (limited) official rate rises.

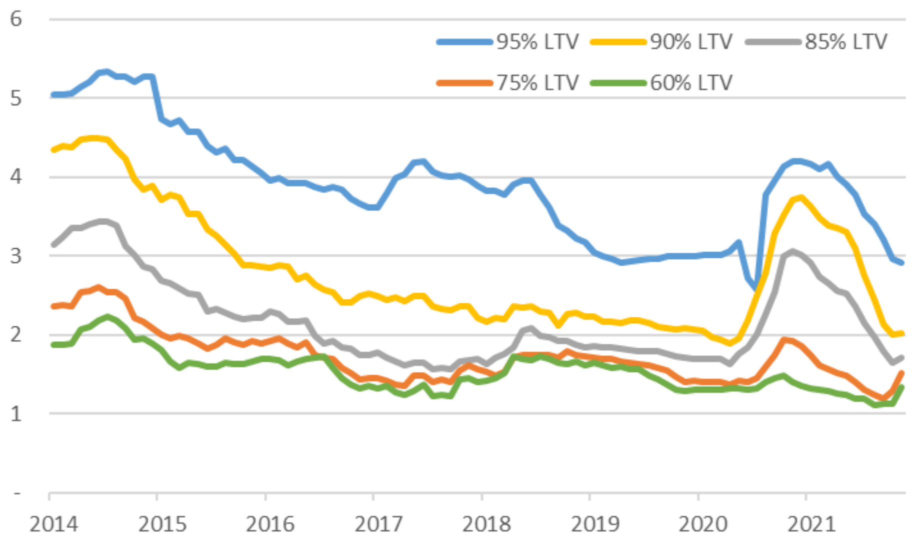
As well as robust price growth, the latest surveys from Rightmove and Zoopla confirm that, away from London, rents are rising at their fastest rate for many years (8.6% and 6% respectively). Rental demand in city centres has rebounded strongly, alongside the resumption of office life, social activities, tertiary education and travel, against the backdrop of limited available stock.

The resurgence in London in recent months has been especially strong and rapid, even though average rents are still lower than pre-pandemic.

Mortgage products

After trending lower across the board since late 2020, as lenders' capacity and appetite to lend has strengthened and competition intensified, mortgage rates have nudged higher in recent weeks.

Chart 4: Quoted rates, 2-year fixed rate mortgages, % pa



Source: Bank of England

Prior to the reversal in November, fixed rates had moved lower than their corresponding 2019 levels. Despite some increases, 2-year fixed rates are materially lower than at the start of the year, except for the lowest LTV products which are back to where they started.

Trends for 95% LTV products have been a little different, as product availability and competition continues to be boosted by the Government's Mortgage Guarantee Scheme (open until the end of 2022) and other initiatives. Since their peak early in 2021, the premia for 95% LTV products over their 75% LTV counterparts has narrowed by nearly a full percentage point for 5-year fixes and by about 120 bps for 2-year fixes, according to Bank of England figures. More recently, Moneyfacts has reported that average 2- and 5-year fixed rates for 95% LTV products are at record lows.

Budget and Spending Review 2021: housing measures

The Budget and Spending Review were low-key as far as housing is concerned, with few new measures announced.

Highlights include:

Residential Property Developer Tax (RPDT)
First trailed in February 2021, a new tax from April 2022 on UK residential property developers, as a contribution towards to building safety remediation post-Grenfell. Tax to be charged at 4% on annual profits over £25 million.

Capital Gains Tax (CGT)
From 27 October 2021, the deadline to report and pay CGT after selling UK residential property will increase from 30 days after the completion date to 60 days (as recommended by the Office of Tax Simplification).

Housing supply
An additional £1.8 billion for housing supply, to meet the government's commitment to deliver £10 billion investment since the start of this Parliament and unlock over 1 million new homes over the SR21 period and beyond. Includes £300 million locally-led grant funding to be distributed to Mayoral Combined Authorities and Local Authorities to unlock smaller brownfield sites for housing and improve communities in line with their priorities, and £1.5 billion to regenerate underused land and deliver transport links and community facilities, unlocking 160,000 homes in total.

Affordable Homes Programme (AHP)
Reconfirms £11.5 billion investment through the AHP (2021-26), of which £7.5 billion is over the SR21 period. Delivers up to 180,000 affordable homes. 65% of the funding for homes outside London.

Planning regime
An additional £65 million investment to improve the planning regime, through a new digital system which will ensure more certainty and better outcomes for the environment, growth and quality of design.

Cladding
Confirms over £5 billion grant funding to remove unsafe cladding from the highest-risk buildings, of which £3 billion is over the SR21 period. Supported by revenues raised from RPDT.

Climate change
A 3-year £450 million scheme offering households grants of up to £5,000 to reduce the cost/encourage take-up of heat pumps. Further support of £338 million to encourage private investment heat networks in England. £950 million for Home Upgrade Grant and £800 million for Social Housing Decarbonisation Fund to help low-income households in England make their homes more energy efficient and reduce their energy bills.

Macro-prudential

In its latest review of its mortgage market measures (see section 3 of the *Financial Stability Report December 2021*), the Financial Policy Committee (FPC) concludes that its housing tools continue to guard against a loosening in underwriting standards and a material increase in household indebtedness.

The FPC is not persuaded that the structural decline in interest rates justifies a change in the overall calibration of its mortgage market measures, and so wishes to keep the broad thrust of its current policy unchanged.

That said, the FPC has looked closely at how the LTI flow limit and affordability tests perform and concluded that the LTI flow limit, without the affordability test but alongside the FCA's affordability testing under its Mortgage Conduct of Business framework, ought to deliver an appropriate level of resilience to the UK financial system, but in a simpler, more predictable and more proportionate way.

The FPC therefore intends to maintain the LTI flow limit, but consult, in the first half of 2022, on withdrawing its affordability test.

The mortgage industry has welcomed the outcome of the FPC's review, which will give lenders a little more flexibility in setting their underwriting standards.

The most likely beneficiaries from the change in policy are first-time buyers looking to purchase in London and the South East, where stress tests have curtailed borrowing capacity and resulted in onerous deposit requirements.

Green issues

The Government's *Net Zero Review* and *Heat and buildings strategy* reports, released in the run-up to the COP26 climate conference in Glasgow, raised few fresh issues for the industry and were seen more widely as a little underwhelming.

SR21 (see boxed article) did feature measures to improve the energy efficiency of homes and promote heat pumps and district heating schemes, but the scale of investment is not transformational in nature.

The development of policy has also been slow.

It is understood that landlords will now have until 2026 to ensure that properties subject to new lettings have an energy performance certificate (EPC) rating of C or higher. But the industry still awaits a government response to a BEIS consultation on the role that lenders could play to improve the energy performance of mortgaged properties. A third consultation paper, looking at how to make property owned outright more energy-efficient has yet to appear.

Understandably, there has been a greater focus on green mortgages in recent months, and this will grow over time as part of a broader focus on ESG issues. MoneyFacts reports that the availability of green mortgage products is improving, albeit from a low base, and the ability to filter such products is being rolled out in mortgage sourcing systems. The Green Finance Institute has also launched its Green Mortgage Hub, an online resource collating publicly-available information on UK green mortgages into an interactive table, alongside a library of articles, report, tools and pilots related to the green mortgage market.

Last March, the Chancellor Rishi Sunak extended the Bank of England's policy remit to include supporting the Government's efforts to transition to a net zero economy. The FCA and PRA have recently published climate change adaptation reports. Both signal a more active policy going forwards, with the PRA planning to review what changes to the regulatory capital framework would be appropriate in the light of climate-related financial risks.

Steps to green our homes will necessarily be a very costly and slow-burn process (pun intended), with surveys highlighting homeowner ignorance about the EPC rating of their homes and appropriate measures to reduce energy usage and bills.

Mortgage prisoners

The FCA's *Mortgage Prisoner Review* has recently been laid before Parliament. This sets out the loan and borrower characteristics of the wider population of 195,000 mortgages in closed books with inactive firms. The FCA estimates that 47,000 of these are mortgage prisoners – borrowers who are up-to-date with payments but cannot switch when it might benefit them to do so, because they have loan and/or borrower characteristics that are outside current lender appetite.

The report notes that to date only 200 mortgage prisoners have switched to new deals as a direct result of the FCA allowing lenders to use modified affordability assessments. The low figure reflects limited interest from lenders, in part reflecting the impact of the coronavirus pandemic, and limited engagement from borrowers on closed books.

One of the motivations for producing this report is to encourage lenders to consider if they can amend their lending criteria to lend to mortgage prisoners who are close to their risk appetite. The FCA estimates that up to around 6,000 mortgages held by mortgage prisoners might fall into this category (para 4.71).

High LTV schemes

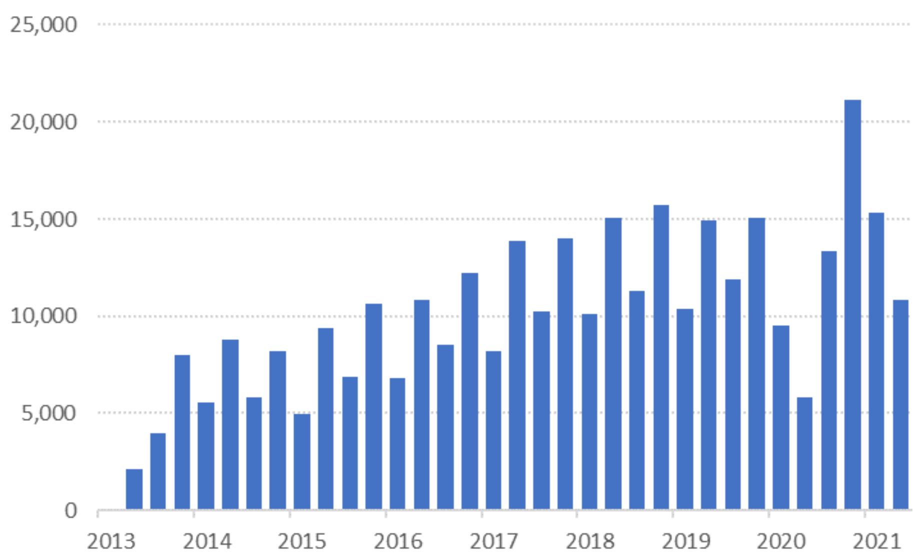
The market for higher LTV products continues to evolve positively. In 2021 Q3, around 16% of new lending to owner-occupiers was at an LTV ratio of 90% or above, compared to 10% in 2021 Q2 and 20% in 2019 Q4, according to the FPC.

More than 800 95% LTV mortgages were completed through the Government's mortgage guarantee scheme in the second quarter, following the scheme's launch in mid-April. While only a very small fraction of overall lending, the scheme is likely to have played an important role in that quarter's rising trajectory of high LTV completions.

The Government has recently launched its new "Help to Build" scheme for self-builders and custom build projects. Modelled on the Help to Buy Equity Loan scheme, borrowers will be able to apply for an equity loan of between 5% and 20% of the total estimated land and build cost (up to 40% in London), which is interest-free for five years. The new scheme is due to run for 4 years.

Meanwhile, the latest figures for the Help to Buy Equity Loan scheme show that more than 60,000 sales completed in the year to June, the strongest showing to date. In Q2 10,824 properties sold through the Help to Buy Equity Loan scheme. Although both the previous (2013 to 2021) and current (2021 to 2023) schemes were running simultaneously during this quarter, the vast majority of properties (96%) were bought by first-time buyers.

Chart 5: Help to Buy Equity Loan scheme quarterly completions



Source: DLUHC

We also continue to see innovation in the private sector.

The first completions under Deposit Unlock - the housebuilding industry-led and reinsurance-backed mortgage scheme that allows new build buyers to purchase with a 5% deposit – have taken place and the scheme has now launched nationally with 17 major builders.

Private equity loan products also appear to be gaining early traction.

Arrears and possessions

Arrears remain close to historic lows in Q3, according to UK Finance.

While short-term arrears are lower than corresponding pre-pandemic figures, longer-term cases – those with balances of 10% or more - are noticeably higher though still low by historical standards. This reflects the fact that possession and subsequent sale activities effectively ceased during the pandemic period. Court proceedings have restarted, initially focused on cases pre-dating Covid, with possessions climbing in Q3 from near-negligible levels over the past year.

With the furlough scheme now ended and mounting cost of living pressures, the industry anticipates that arrears and possessions are now on an upwards trajectory, albeit one that should be relatively modest.

A survey commissioned by the National Residential Landlords Association (NRLA) offers the positive news that the proportion of tenants who had built arrears since March last year that still needed to be paid off has almost halved to 3.7%.

This still leaves over 430,000 private renters with such arrears.

The Department for Levelling Up, Housing and Communities has recently announced a £65m package for councils in England to support households who are behind on their rent, albeit this follows the end of the £20 Universal Credit uplift which will worsen rent arrears.

Prospects

How the Omicron variant plays out will be a key determinant of the fortunes for the mortgage market and wider UK economy over the coming months.

Mortgage lenders will have robust contingency plans in place to ensure that high service levels are maintained and customer needs looked after, but a significant ratcheting-up of social distancing arrangements would represent an unwelcome retrograde step for the sector. The hope is that concerns over Omicron turn out to be overstated and that lenders, intermediaries, the Government and other stakeholders can focus their attention on developing a greener, more resilient and sustainable housing market across all tenures and all life-stages.